Office of Chief Counsel
Internal Revenue Service

memorandum

CC:WR:SCA:LN:TL-N-7999-98
LNPrimavera

date: MAY 10 1999

to: Revenue Agent Jill El-Bendary
Long Beach POD

from: Lisa N. Primavera, Attorney
June Y. Bass, Assistant District Counsel
Southern California District Counsel, Laguna Niguel

---

subject: Request for Legal Opinion [redacted]

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

DISCUSSION

We write in response to your request for a legal opinion. You have met with attorney Lisa Primavera of our office at various times to discuss the issues presented and to present additional facts developed. You met most recently on February 24, 1999 and discussed facts developed through your interview with the taxpayers.

ISSUES

1. Whether the taxpayers can avoid the limitation of I.R.C. § 67 on deduction of employee business expenses and the disallowance of such deductions for alternative minimum tax purposes by passing their income and expenses through a partnership.

2. Whether the taxpayers are employees of [redacted] or independent contractors.

CONCLUSION

1. The taxpayers cannot use the partnership to avoid the limitation of I.R.C. § 67 on deduction of employee business expenses and the disallowance of such deductions for alternative minimum tax purposes.

2 . The taxpayers appear to be employees of [redacted]. However, we suggest further factual development to solidify the case.

FACTS

Background

You are examining the [redacted] federal income tax returns of [redacted] and [redacted] ([redacted]) and [redacted] ([redacted]) are [redacted] [redacted] is also known as [redacted] or [redacted] Each has been in the business commonly referred to as "stock brokerage" for many years.

It is not clear from the file whether [redacted] was a broker registered with the Securities Exchange Commission or was a person associated with a registered broker. (We discuss the law pertaining to SEC registration for brokers in the LAW section of this memo). We will assume for purposes of discussion that the individuals were not registered with the SEC, but were associated with firms (such as [redacted] and [redacted]) who were registered brokers.[1]

The Partnership Agreement

Prior to [redacted] and [redacted] worked for [redacted] ([redacted]), a registered brokerage firm. They were [redacted] working for [redacted] in [redacted]. On [redacted] the [redacted] executed a Partnership Agreement. The agreement purported to establish a partnership

---

[1] These facts should be clarified with the taxpayers.

for the purpose of "uniting the business" of "investment brokerage, financial consultancy and management of client assets." The partnership agreement lists other business activities such as [redacted]

It appears that [redacted] used the trade name [redacted] prior to [redacted]. After the [redacted] executed the partnership agreement, the name the [redacted] was used by [redacted][2]

The "investment brokerage, financial consultancy and management of client assets" was the business that each [redacted] was in, in his capacity as an employee of [redacted]. This is explicitly acknowledged in paragraph 4 of the partnership agreement.

The partnership agreement allocates income and expenses as follows:

> "net compensation after deduction of business expenses shall be [redacted]% allocation [sic] to [redacted] and [redacted]% to [redacted] of the [redacted]. Said proration shall be subject to review and amendment both as to the proration of revenues and expenses with the agreement of both parties."

In reality, the allocation of income exactly matched the income received by each from [redacted] and later [redacted]. Expenses were allocated to each in accordance with who incurred the expense. In other words, there was no "allocation" of income or expenses; each "partner" continued to receive his own compensation from [redacted] and pay his own expenses.

There does not appear to have been any income produced from any other line of business in the years you reviewed

<u>The [redacted] relationship</u>

In [redacted] the taxpayers were hired as account executives by [redacted]. [redacted] was given the title [redacted] and [redacted] was given the title [redacted]. Each [redacted] was hired pursuant to an individual hiring memorandum. The Inter-Office memos regarding the hiring of each [redacted] state at the bottom as follows:

> The arrangement set forth herein is not a guarantee of employment for any specific period of time and is not an employment contract. The terms set forth herein are based upon satisfactory performance by the employee while employed at [redacted]. [redacted] does not waive its right to terminate any employee for failure to adhere to regulatory or Firm policies, or to perform

---

[2] A search of LEXIS for fictitious name filings in the Southern California area did not show a filing for the [redacted].

satisfactorily.

The [redacted] are paid on a commission only basis. However, at the commencement of the employment, each received an interest-free forgivable loan. The loan was payable in ten equal annual installments. Each installment would be forgiven so long as the borrower was employed by [redacted] on the due date. If the employment was terminated, the entire outstanding principal balance would become due and payable with interest from the date of termination. Each [redacted] signed a promissory note evidencing the loan obligation due from him individually. The loans were not made to the partnership or in the name of the [redacted].

[redacted] allows the taxpayers to use the trade name [redacted] for advertising purposes. For example, the building directory in the lobby of the building in which the [redacted] office is located shows a listing for the [redacted]. Customer statements issued by [redacted] show the [redacted] as the name of the customer's financial consultant. The taxpayers maintain a yellow pages listing under the [redacted].

The taxpayers maintain a bank account in the name of the [redacted]. [redacted] deposits the taxpayers' commissions into that account. Notwithstanding that [redacted] allows the use of the name [redacted] and deposits the taxpayers' income into a "partnership" account, [redacted] treats the taxpayers as employees in their individual capacities. It issues W-2's for wages and withholds income tax and FICA, and pays FICA and FUTA taxes on the taxpayers' wages.

[redacted] provides life, health and disability insurance for each [redacted] [redacted] also included the [redacted] in its 401(k) plan, stock purchase plan and pension plan.

[redacted] provides the [redacted] with office space, computer equipment, market quote service and research material. [redacted] also provides a full time sales assistant. The salary of another assistant is paid [redacted]% by [redacted] and [redacted]% by the taxpayers.

[redacted] has the right to monitor the trades and check for, among other things, unusual concentrations of particular securities and churning of accounts. [redacted] can limit a broker's concentration in positions. Trades are regularly reviewed by [redacted] for compliance with regulations of regulatory agencies. Trading errors are deducted from their commissions. [redacted] also monitors accounts to determine whether investments recommended by the taxpayers meet the profile and objectives of the clients. Complaints by clients must be referred to [redacted] management.

The [redacted] must attend compliance training provided by [redacted].

[redacted] must approve of all form letters sent by taxpayers to clients. All outgoing

correspondence is maintained in [redacted]'s files.

[redacted] must approve of the following outside activities:

Serving on a Board of Directors
Speaking engagements related to investing ([redacted] must approve content of speech)
Statements to the press.

The taxpayers' treatment of expenses for tax purposes

The [redacted] report their W-2 income on a Form 1065 filed in the name of the [redacted]. They report the income as gross receipts on line 1. From that amount they deduct, among other things, the expenses they incur in their activities as account executives of [redacted]. They then pass through the net amount as partnership income on the K-1s.

If the taxpayers are employees of [redacted], the expenses they incurred in the course of their employment would constitute employee business expenses. As such they are subject to the limitations of I.R.C. § 67.

The taxpayers contend that the effect of the partnership arrangement is that the taxpayers avoid the limitations of I.R.C. § 67 on employee business expenses. They also avoid the limitation on deductions of miscellaneous itemized deductions for purposes of computing alternative minimum tax. I.R.C. § 55 and 56.

LAW

Employee Business Expenses

A taxpayer may deduct from gross income, trade or business expenses, "which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee." I.R.C. § 62(a)(1) (emphasis added). Generally, section 62(a)(1) permits all deductions attributable to the taxpayer's trade or business to be subtracted in computing adjusted gross income. Employees, however, under section 62(a)(2) may deduct expenses incurred "in connection with the performance . . . of services as an employee" in determining adjusted gross income only if the expenses are covered by a reimbursement arrangement with the employer. Non-reimbursed employee business expenses are only deductible from adjusted gross income as an itemized deduction and are subject to the two-percent floor on miscellaneous itemized deductions. I.R.C. §§ 162 and 67.

I.R.C. § 67 provides that certain miscellaneous itemized deductions are deductible only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income. Employee business expenses are such "miscellaneous itemized deductions." Further, for

purposes of computing alternative minimum taxable income deductions for miscellaneous itemized deductions are disallowed. I.R.C. § 56(b).

Section 67(c) provides specifically for regulations which prohibit the indirect deduction through pass-thru entities of amounts which would be subject to the limitation if incurred directly by an individual.

Treas. Reg. § 1.67-2T provides that deductions subject to the 2 percent floor shall be taken into account separately for each partner. That is, such deductions are not deducted from any partnership income and passed through as net income or loss to the partners, but must be separately identified as miscellaneous itemized deductions and passed through as such.

Section 67 was added to the Code by the Tax Reform Act of 1986, P.L. 99-514 and was effective for tax years beginning after December 31, 1986.

Employee v. Independent Contractor

Section 3121(d)(2) of the Internal Revenue Code defines "employee" as any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

The question of whether an individual is an employee under the common law rules or an independent contractor is one of fact to be determined upon consideration of the facts and the application of the law and regulations in a particular case. Guides for determining the existence of that status are found in three substantially similar sections of the Employment Tax Regulations, namely, sections 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1, relating to the FICA, the FUTA, and federal income tax withholding, respectively.

Section 31.3121(d)-1(c)(2) of the regulations provides that generally, the relationship of employer and employee exists when the person for whom the services are performed has the right to control and direct the individual who performs the services not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but as to how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he or she has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is the employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is an independent contractor.

In determining whether an individual is an employee under the common law rules, twenty factors have been identified as indicating whether sufficient control is present to establish an employer-employee relationship. The twenty factors have been developed based on an examination of cases and rulings considering whether an individual is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. See Rev. Rul. 87-41, 1987-1 C.B. 296. However, that list is merely an analytical tool and does not supplant the legal control test set forth in the statute. While IRS agents have traditionally focused on the twenty factor list, many of the factors contained in that list are not as relevant today. See, Weber v. Commissioner, 103 T.C. 378 (1994), aff'd per curiam, 60 F.2d 1104 (4th Cir. 1995); Kenney v. Commissioner, T.C. Memo. 1995-431.

An analysis of the control element in a worker classification case may be grounded upon an examination of the following three (3) categories of evidence: (1) behavioral control exerted over the worker, (2) financial control exerted over the worker, and (3) the relationship of the parties. Specific facts to examine regarding the behavioral control prong include instructions and training provided to the workers. Facts which illustrate the existence of financial control include: the method of payment, the worker's opportunity for profit or loss, whether the worker's services are available to the market at large, the existence of unreimbursed expenses, and whether the workers invest in the activity. Finally, one may consider the following facts in determining how the parties view their relationship: the existence of employee benefits, whether the activity is regular, the intent of the parties, the existence of written contracts, and the right to terminate the services of the worker. The factors listed herein constitute a non-exhaustive list of relevant factors and allow for a fluid analysis on the control element set forth in the statute. This form of analysis should therefore be preferred to a mechanical application of the factors set forth in Rev. Rul. 87-41.

Consideration must also be given to such factors as the continuity of the relationship and whether or not the individual's services are an integral part of the business of the employer as distinguished from an independent trade or business of the individual himself in which he assumes the risks of realizing a profit or suffering a loss. See United States v. Silk, 331 U.S. 704 (1947), 1947-2 C.B. 167, and Bartels v. Birmingham, 332 U.S. 126 (1947), 1947-2 C.B. 174.

Section 31.3121(d)-1(a)(3) of the regulations provides that if the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such relationship exists, it is of no consequence that the employee is designated as partner, coadventurer, agent, independent contractor, or the like.

In Gierek v. Commissioner, T.C. Memo. 1993-642, the Tax Court has held that a stockbroker was an employee rather than an independent contractor. In Gierek, the taxpayer worked as a stockbroker for a brokerage firm. He was paid on commission and received Forms W-2 reflecting his commission income. His employer withheld FICA and federal income tax from the taxpayer's pay. The taxpayer held the title Vice President at the brokerage firm. The

firm paid all the taxpayer's licensing fees and provided him with office space, equipment, market quotes and research material. The taxpayer also used his own computer and purchased additional research not provided by the firm. The firm provided sales assistants to the taxpayer and deducted a portion of the assistants' wages from the taxpayer's commission. The taxpayer incurred some expenses for supplemental clerical services. The taxpayer was liable to reimburse the firm for trading errors. The firm provided life, health and disability insurance for the taxpayer and the taxpayer participated in the firm's 401(k) plan.

The firm exercised substantial control over the taxpayer. It monitored his activities to ensure compliance with legal and regulatory standards. It also ensured that the investments recommended by the taxpayer were appropriate for the client. All speaking engagements by the taxpayer had to be approved by the firm and the script submitted in advance for approval. Also, brokers could have no contact with the press without the prior approval of the firm.

The Court found that Gierek was an employee of the firm. The Court's opinion recognizes that some of the facts could support a finding that the taxpayer was an independent contractor, however, the preponderance of the evidence lead to the finding that he was an employee. The Court rejected the taxpayer's argument that because he was liable for trading errors, he was an independent contractor.

The Court's factual recitation suggests that it gave substantial weight to the firm's monitoring of the taxpayer for compliance purposes. The opinion does not address the issue of whether such monitoring exceeded the supervision required of the firm by the SEC and NASD.

The Service has addressed such issue in two revenue rulings and two private letter rulings.

Rev. Rul. 76-138, 1976-1 C.B. 315, ruled that the securities salespeople described are employees because a preponderance of the facts indicate that the "employer" actually does exercise or has the right to exercise "direction and control" over the "employee" based on all the facts and circumstances. The facts state that the Firm had contracts with the Workers that could be terminated immediately by either party. The Firm furnished the Workers with office space, telephone service and all necessary accounting records reflecting transactions made by the Workers. The Workers were given manuals to insure adherence to the rules and regulations of the company as well as the NASD. The manual instructed the Workers to consult with Firm supervisors before taking certain matters into their own hands, such as when a formal complaint is filed by a customer. The Firm reviewed the Workers' correspondence with customers to verify reasonableness, and the Workers were not permitted to perform services for the public without the Firm's permission. The Workers were paid commissions by the Firm and were entitled to a monthly draw. The Workers paid their own traveling, entertainment and other expenses, but they participated in the Firm's sponsored workmen's compensation, and were offered the opportunity to participate in group life, health and accident insurance plans.

Rev. Rul. 76-138 also states that exchange and association regulations and licensing statutes of the type involved were intended to insure legal and ethical conduct by salespeople to protect the securities industry and the public against fraudulent dealing. To the extent that the company and the salespeople contemplate that such regulations and statutes will be enforced by the company, even though initiated by outside parties rather than the company, the effect on the salespeople's everyday activities should be considered along with other evidence to determine whether the requisites of an employee-employer relationship exist.

In Rev. Rul. 76-136, 1976-1 C.B. 313, where securities salespeople were held to be independent contractors, the Service noted that the Firm: (1) did not pay most of the Worker's ordinary expenses, licensing and registration fees; (2) did not implement controls to obtain the Worker's conformity to it own rules and those of the stock exchange and regulatory agencies; and (3) did not require the Workers to secure the Firm's approval on all new accounts or subject the Worker's correspondence and portfolio record books to scrutiny. Moreover, the Firm did not maintain a draw system for the Workers, nor did it provide training or group insurance programs for the Workers.

Rev. Rul 76-136 was revoked by Rev. Rul. 78-365, 1978-2 C.B. 254. Rev Rul. 78-365 reinstated Mim. 6566, 1951-1 C.B. 108. Mim. 6566 holds that securities salesmen who perform their services under circumstances and conditions such as those present in Dimmitt-Rickhoff-Bayer Real Estate Co. v. Finnegan, 179 F.2d 882 (8th Cir. 1950), are not employees for purposes of the employment taxes and the income tax withholding, in the absence of other substantial evidence of an employee-employer relationship. The facts of Dimmitt are similar to those set forth in Rev. Rul. 76- 136. In addition, Mim. 6566 indicates by inference that the fact that brokers are required to conform to regulatory legislation and established customs and practices of the industry will not, in and of itself, be a sufficient indication of employer control to establish employee status. Rather, the existence of additional factors, such as close supervision or control of the Worker's activities by the brokers on a regular basis would have to be shown in order to classify the salesperson as an employee.

Dimmitt held that certain real estate salespeople are not employees. In Dimmitt, the workers paid all the costs of transportation. The real estate agency's manual was advisory only and failure to follow it did not constitute cause for termination. The Dimmitt court noted that all the workers had been engaged in the business previously and enjoyed a good reputation for fair and honest dealing with the public. In distinguishing the Dimmitt workers from those of case law finding an employment situation, the court noted that Dimmitt was concerned with competent salesmen, almost entirely dependent upon their own initiative, efforts, skill, and personality for success, working upon their own time, at their own expense, and deriving their remuneration for the results of their work.

Two private letter rulings discuss the above-referenced revenue rulings. Ltr. Rul. 9240019 and Ltr. Rul 933007 both deal with situations in which workers for securities broker-dealers were found to be employees.

In Ltr. Rul 9240019, the employer Firm was a registered broker-dealer and a member of the National Sercuties Dealers Association (NASD) . The employee was a registered representative under the Securities Exchange Act of 1934 and NASD Rules. The worker performed services pursuant to a written agreement. The Firm gave the worker instructions in accordance with the rules and regulations of the NASD and the Security and Exchange Commission (SEC), and supervised the worker. The firm had the right to change the methods used by the worker. All sales of a Registered Representative were required to be reported to and reviewed by the Office Manager.

The firm provided product and sales training and compliance training for the workers. The compliance training was mandated by the rules of the NASD. The worker could be terminated for repeated failure to attend the meetings.

The firm provided the worker with office space, filing cabinets, computers, etc. It also supplied sales materials. The firm did not pay for licensing fees or other expenses incident to selling. The employee was paid on commission.

In ruling that the worker was an employee, the Service noted particularly that the firm also established workplace rules and criteria that went beyond those required by the NASD and SEC.

In Ltr. Rul 9330007, the issue was whether cetain securities salespeople who worked for a registered broker dealer firm were employees. The Firm provided a manual to its workers setting forth the policies and practices to which the worker must adhere. The Firm supervises the workers in accordance with the SEC and NASD requirements. Additionally, the Firm has its own particular methods and instructions for workers to follow in conducting business.

The Service ruled that the workers were employees because the Firm had the right to and did exercise significant control over how the workers performed their jobs. The ruling pointed out that the Firm exercised control over the employees beyond the supervision required by the SEC and NASD.

Securities Regulation

The Securities Exchange Act of 1934, 15 U.S.C. § 78a et seq., establishes the definitions and rules under which securities may be bought and sold in interstate commerce. It is illegal to act as a broker (one who is engaged in the business of effecting transactions in securities for the account of others) or dealer (one who is engaged in the business of buying and selling securities for his own account), unless such person is registered with the Securities Exchange Commission or is associated with a registered broker or dealer which is a person other than a natural person (e.g., a corporation). 15 U.S.C. § 78o(a)(1). Further a registered broker or dealer must be a member of a securities association registered under 15 U.S.C. § 78o-3 (e.g., NASD) or must limit

its transactions in securities solely to a national exchange of which it is a member. 15 U.S.C. § 78o(b)(8).

A broker or dealer is liable for sanctions if it or any person associated with it violates federal securities law. 15 U.S.C. § 78o(b)(4).

The National Association of Securities Dealers is a securities association registered under 15 U.S.C. § 78o-3. NASD, as a registered securities association must, among other things, establish and enforce written procedures for supervising registered representatives with a view towards achieving compliance with applicable securities laws and regulations. The National Association of Securities Dealers refers to a person who is associated with a registered broker or dealer as a "registered representative." The NASD Manual provides in exquisite detail, the procedures for reviewing transactions and supervising registered representatives.

ANALYSIS

The taxpayers claim that the expenses incurred in their business activities as stock brokers are fully deductible from their income. They argue that since the income is earned by a partnership, the individuals are not employees of [redacted] and the expenses incurred are not, therefore, employee business expenses.

The taxpayers' argument is without merit.

I.R.C. § 67(c) specifically prohibits the use of pass-thru entities to disguise what otherwise would be miscellaneous itemized deductions in order to avoid the application of the two percent floor. The "partnership agreement" was executed shortly after the provisions of I.R.C. § 67 were added to the law. It seems clear that the arrangement implemented by the taxpayers is the very type of situation Congress intended to prohibit by the provisions of section 67(c).

The facts are clear that, although [redacted] allowed the taxpayers to use the partnership name the [redacted] for advertising and marketing purposes, [redacted] employed each taxpayer as an individual. It did not enter into any employment contract with the partnership. Other than the use of the name "[redacted]" for marketing purposes, the taxpayers have provided no evidence that such a relationship existed between [redacted] and the partnership.

Thus, the treatment of the expenses incurred in the taxpayers' stock brokerage activities depends on whether the individuals are employees of [redacted] or independent contractors.

In this case several factors weigh strongly in favor of a finding that the taxpayers were employees of [redacted].

First, [redacted] actually considered them employees. [redacted] withheld FICA taxes and income tax withholding. [redacted] issued forms W-2 to each of the taxpayers. Also, the taxpayers were included in the company 401(k), stock purchase and pension plans. [redacted] also provided life, health and disability insurance.

Second, [redacted] retained the right to terminate the taxpayers for failure to follow Firm policies or to perform satisfactorily.

Third, [redacted] provided the taxpayers virtually all of the office space, equipment, computer systems, quotation and research service, and assistance that the employees required to carry out their duties. The amounts of salary paid to assistants by the taxpayers are relatively insignificant compared to the total salary and benefits paid for their office assistants. The taxpayer's cannot be said to have any significant capital investment in the business.

Fourth, the taxpayers were given the titles, [redacted] and [redacted]. Such positions indicate that the relationship between the taxpayers and the company was more than just an independent contractor/client relationship. Clearly, the implication of the title [redacted] is that the individual has an ongoing relationship to the company and is an integral part of the company's business.

Fifth, [redacted] exercises significant control over the taxpayers in determining how the taxpayers conduct the business. Some of this control is due to [redacted]'s obligation under the rules of the SEC and NASD to supervise its registered representatives. To the extent that the control is a requirement of law and regulation, it may be less important in the determination of the status of the taxpayers as employees. This is so since [redacted], as a broker dealer would be required to exercise the same supervision over individuals with whom it had a true independent contractor relationship if those individuals were registered representatives.

However, it appears that [redacted] may go beyond the requirements of the industry rules in controlling the activities of the taxpayers. For example, customer complaints must be referred to a manager of [redacted]. This suggests that the taxpayers were subject to managerial direction and control and were not acting as independent agents. In this regard, we suggest that the employee manuals of [redacted] be obtained. They should provide good evidence of the nature and extent of the control exercised by [redacted].

RECOMMENDATION

We recommend that you obtain the employee manuals of [redacted] to determine the extent of the direction and control exercised over the taxpayers. We will be happy to assist you in reviewing the employee manual and determining the extent to which the control may have exceeded the control required by the SEC and NASD.

If you have any questions, please phone attorney Lisa Primavera at (949) 360-2689.